

Southwestern Bell *Delphi*

ORIGINAL  
FILE

RECEIVED

JUL 31 1992

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

July 30, 1992

Richard C. Hartgrove  
General Attorney

Ms. Karol Sweitzer  
Director-Federal Regulatory  
Southwestern Bell Corporation  
1667 K Street, N.W., Suite 1000  
Washington, D.C. 20006

Dear Karol:

Re: Rebuttal of Southwestern Bell Telephone Company,  
CC Docket No. 92-101, Transmittal No. 497, Transmittal  
No. 246 and Transmittal No. 1579

Enclosed please find an original and seven (7) copies of the  
above-referenced pleading to be filed with the Secretary of  
the Commission on Friday, July 31, 1992.

Additional copies of the pleading are attached to be used as  
courtesy copies and one is included for your files.

Please call to confirm that the pleading has been filed.  
Thank you for your assistance.

Very truly yours,

*Richard C. Hartgrove*

Enclosure

1010 Pine Street  
St. Louis, MO 63101

Phone 314 235-2506

No. of Copies rec'd 0+7  
List A B C D E

RECEIVED

JUL 31 1992

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

BEFORE THE  
FEDERAL COMMUNICATIONS COMMISSION  
WASHINGTON, D.C. 20554

In the Matter of )

Treatment of Local Exchange Carrier )  
Tariffs Implementing Statement of )  
Financial Accounting Standards, )  
"Employers Accounting for )  
Postretirement Benefits Other Than )  
Pensions" )

CC Docket No. 92-101

Bell Atlantic Tariff F.C.C. No. 1 )

Transmittal No. 497

US West Communications, Inc. Tariff )  
F.C.C. Nos. 1 and 4 )

Transmittal No. 246

Pacific Bell Tariff F.C.C. No. 128 )

Transmittal No. 1579

TO THE COMMISSION

REBUTTAL OF  
SOUTHWESTERN BELL TELEPHONE COMPANY

DURWARD D. DUPRE  
RICHARD C. HARTGROVE  
THOMAS A. PAJDA

1010 Pine Street  
Room 2114  
St. Louis, Missouri 63101  
(314) 235-2507

ATTORNEYS FOR  
SOUTHWESTERN BELL TELEPHONE COMPANY

July 31, 1992

Rebuttal of  
Southwestern Bell Telephone Company

Table of Contents

<u>Subject</u>	<u>Page</u>
Summary	i
I. INTRODUCTION . . . . .	2
II. THE COSTS OF IMPLEMENTING SFAS-106 ARE EXOGENOUS. . . . .	2
A. SFAS-106 Results In An "Actual Cost." . . . . .	3
B. The LEC Accruals Do Not Double Count SFAS-106 Costs And Therefore Pass All Parts Of The FCC's Three-Part Test For Exogenous Treatment. . . . .	4
1. Not All Firms Will Raise Prices. . . . .	6
2. A One-time Increase In The Price Level, Not A Permanent Increase In Inflation, Was Used in The Studies. . . . .	7
3. SWBT's Present Value Calculations Have Been Purged Of Expected General Inflation. . . . .	8
4. The GNP-PI Used In The Price Cap Index Should Include The Medical Care Component. . . . .	9
C. Prefunding Need Not Be Required. . . . .	11
D. Opponents' Arguments Disregard The Fixed Effect Of SFAS-106. . . . .	13
1. SFAS-106 Costs Are Unlike Depreciation Rate Changes. . . . .	14
2. FCC Rejection Of Exogenous Treatment For Equal Access Is Not Pertinent. . . . .	16
3. MCI Mischaracterizes the Relationship Between OPEBs and Wages. . . . .	17
4. An Arbitrary Limitation On The SFAS-106 Accrual Amount To Be Given Exogenous Treatment Is Inappropriate. . . . .	20

E.	LECs Need Not Further Demonstrate The Disproportionality of SFAS-106 Expenses. . . . .	21
F.	Denial Of Exogenous Cost Recovery Of SFAS-106 Costs Is Not Necessary To Achieve An Appropriate Balance Between Risk And Reward For Price Cap LECs. . . . .	23
1.	Exogenous Cost Recovery Of SFAS-106 Costs Is Not An Opportunity For Increased Profits. . . . .	23
2.	It Is Irrelevant To Determine Whether The Obligations Estimated Under SFAS-106 Are Not Legally Binding. . . . .	24
3.	An Exogenous Cost Showing Need Not Satisfy A "Confiscation" Standard. . . . .	25
G.	Exogenous Cost Treatment Does Not Interfere With Orderly Administration Of The Price Cap System. . . . .	27
1.	Ad Hoc Essentially Argues That the SFAS-106 Issues Need Not Be Addressed Because They Are Difficult. . . . .	27
2.	The Intent Of The Commission's Price Cap Plan Does Not Conflict With Exogenous Treatment of SFAS-106 Expenses. . . . .	28
H.	LEC Cost Estimates Of SFAS-106 Expense Are Reasonable. . . . .	30
1.	LEC Cost Estimates Are Auditable. . . . .	31
2.	The SFAS-106 Accrual Process Is Not Too Liberal. . . . .	32
3.	ETI Unreasonably Creates New Standards For Exogenous Cost Treatment. . . . .	33
4.	ETI Arguments For IRS or ERISA-type Regulation Of OPEBs Are Irrelevant. . . . .	34
I.	SFAS-106 Costs Are Not Discounted To Some Degree In The Existing Nationwide Average ROR Prescribed For All Carriers. . . . .	35
III.	OTHER CHALLENGES TO SWBT'S DIRECT CASE SHOULD BE REJECTED. . . . .	38
A.	MCI's Concerns About The Level Of Detail Are Without Foundation. . . . .	38
B.	The Godwins Study Correctly Analyses The Effect Of SFAS-106. . . . .	39
C.	The Commission Should Not Mandate Uniform Assumptions. . . . .	40

1.	The Variation In OPEB Costs Between Companies Is Irrelevant. . . . .	41
2.	The Differences Cited By ETI Are Irrelevant. . . . .	42
3.	SWBT's Plan Assumptions Are Not Overly Generous. . . . .	43
4.	Early Retirement Programs Are Included In SWBT Estimates. . . . .	44
5.	SWBT Would Not Object To A Subsequent True-up Of The SFAS-106 Liability If Major Changes Occur. . . . .	45
IV.	CONCLUSION . . . . .	46

### SUMMARY\*

Only four oppositions were filed to the Direct Cases of the LECs and USTA. The oppositions argue that the LECs have not satisfied the criteria to obtain exogenous cost treatment for the change in accounting to SFAS-106. The oppositions also argue that even if allowed, the exogenous cost treatment of SFAS-106 costs should be limited. This Rebuttal responds to all these arguments.

This Rebuttal also references the USTA Rebuttal to counter the arguments of MCI that the current rate of return has already compensated SWBT for OPEB costs, and to counter those arguments that claim that the Godwins Study is flawed. The USTA Rebuttal includes the response of the Godwins organization to the challenges to its study.

For the reasons stated herein, and in SWBT's Direct Case, the Commission should recognize the change in accounting necessary for implementation of SFAS-106 as exogenous cost change.

---

\*All abbreviations used herein are referenced within the text.

RECEIVED

JUL 31 1992

BEFORE THE  
FEDERAL COMMUNICATIONS COMMISSION  
WASHINGTON, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Treatment of Local Exchange Carrier	)	
Tariffs Implementing Statement of	)	CC Docket No. 92-101
Financial Accounting Standards,	)	
"Employers Accounting for	)	
Postretirement Benefits Other Than	)	
Pensions"	)	
	)	
Bell Atlantic Tariff F.C.C. No. 1	)	Transmittal No. 497
	)	
US West Communications, Inc. Tariff	)	Transmittal No. 246
F.C.C. Nos. 1 and 4	)	
	)	
Pacific Bell Tariff F.C.C. No. 128	)	Transmittal No. 1579

REBUTTAL OF  
SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT), pursuant to the Order of Investigation and Suspension released April 30, 1992 by the Common Carrier Bureau (Bureau) of the Federal Communications Commission (Commission),<sup>1</sup> hereby files its Rebuttal to oppositions to its Direct Case.<sup>2</sup>

---

<sup>1</sup> Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Post Retirement Benefits Other Than Pensions" CC Docket No. 92-101; Bell Atlantic Tariff F.C.C. No 1, Transmittal No. 497; US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4, Transmittal No. 246; Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1579; Order of Investigation and Suspension (DA 92-540) (released April 30, 1992) (Investigation Order).

<sup>2</sup> This Rebuttal responds to the following pleadings: American Telephone and Telegraph (AT&T) Opposition to Direct Cases; Opposition of the Ad Hoc Telecommunications Users Committee (Ad Hoc) to Direct Cases; Comments of the International Communications Association (ICA); and MCI Telecommunications Corporation's (MCI) Opposition to Direct Cases. This Rebuttal also responds to the study attached to the Ad Hoc and ICA pleadings authored by David Roddy and Page Montgomery, "Analysis of FAS-106 Effects Under Price Caps" (ETI) and the statement attached to the MCI pleading prepared under the direction of Allan Drazen (Drazen).

I. INTRODUCTION

Only four parties opposed the direct cases filed by SWBT and other local exchange carriers (LEC) and USTA, which supported exogenous cost treatment of SFAS-106 expenses. The small number of opposition filings (together with the fact that one of the parties merely filed the same study used by another party as its own filing) shows that there is no widespread opposition to treatment of SFAS-106 expenses as exogenous. The few oppositions fail to show that SFAS-106 costs should not be treated as exogenous and are unable to successfully challenge SWBT's arguments on the level of SFAS-106 expense which should be treated as exogenous. The Commission should therefore allow price cap LECs to make filings raising their price cap indexes (PCIs) by the appropriate amounts.

II. THE COSTS OF IMPLEMENTING SFAS-106 ARE EXOGENOUS.

The oppositions attempt to misinterpret the Commission's test for exogenous cost treatment, but no party has shown a sufficient basis to reject SWBT's position that SFAS-106 costs are exogenous. The following subsections in this Section II rebut those arguments of the oppositions that claim that none of the SFAS-106 costs should be categorized as exogenous. These oppositions variously claim that exogenous treatment should be denied because of the LECs' failure to satisfy the Commission's rule, or because the LECs have not satisfied new standards that should allegedly be fulfilled in addition to the Commission's rule.

A. SFAS-106 Results In An "Actual Cost."

ETI claims that the economic liability that LECs had when price caps was started will now be recognized, but because there is not an increase in actual cost to the LECs, there is nothing to be passed on to the ratepayer.<sup>3</sup> ETI claims that other firms cannot pass on this "non-cash cost increase,"<sup>4</sup> and that it is merely an accounting change.<sup>5</sup>

In effect, ETI claims that there is an "actual cost" standard for exogenous treatment, in other words, there must be a "cash cost increase" to qualify for exogenous treatment. No such standard exists in the Commission's rules.<sup>6</sup>

The offsets to recording the SFAS-106 liability will be charges to operating expenses which are valid costs of providing service. The fact that SWBT had been on the pay-as-you-go basis of accounting for OPEBs has kept rates artificially low. Employees have, in effect, been earning these benefits in prior years and customers have not been paying for all of these benefits since rates have been based on pay-as-you-go accounting. Without exogenous treatment, the Commission would simply be transferring costs presently incurred on behalf of current customers to future generations of customers or would simply force the LECs to realize

---

<sup>3</sup> ETI at pp. 12-13.

<sup>4</sup> See also MCI at p. 8. (MCI claims that SFAS-106 is nothing more than an accounting change that alters the temporal recognition of costs on financial statements, and does not alter the underlying costs of providing telephone services.)

<sup>5</sup> ETI at pp. 2, 11.

<sup>6</sup> See SWBT Direct Case at pp. 6-7, 11-12.

the additional expense without offsetting rate recovery.

SWBT agrees that moving from a pay-as-you-go to SFAS-106 accounting does not require an additional cash outlay. The key point, however, is that adoption of SFAS-106 causes a large increase in SWBT's annual OPEB expense. Noncash expenses, such as depreciation, pension expense and any other accrued expense, are appropriate in the calculation of regulated cost of service. The Commission has accepted SFAS-106 accrual accounting as appropriate for regulatory accounting, agreeing with the Financial Accounting Standards Board (FASB) that SFAS-106 better reflects the true nature of OPEB costs. Appropriately, rates should reflect the true cost of providing service.

B. The LEC Accruals Do Not Double Count SFAS-106 Costs And Therefore Pass All Parts Of The FCC's Three-Part Test For Exogenous Treatment.

AT&T claims that "double counting will occur as all firms increase prices to reflect higher costs", that "[i]nflation is included in the exogenous cost component and in the GNP-PI" and that the LECs have not "effectively removed this double count."<sup>7</sup> AT&T also alleges that LEC accruals include the present value of future inflation.<sup>8</sup> AT&T argues that "to fix the 'double counting' the FCC should require that the expected change in the GNP-PI be subtracted from the health care inflation component of the SFAS-106

---

<sup>7</sup> AT&T at p. 7.

<sup>8</sup> Id.

accrual."<sup>9</sup>

The "double counting" question is properly a part of the exogenous treatment test for OPEBs. As AT&T notes, however, the LECs have already acknowledged the need to address double counting and have worked with Godwins to quantify the incremental effect on GNP-PI and to remove this effect by reducing the level of incremental SFAS-106 expense for which they seek exogenous recovery.<sup>10</sup> In fact, Godwins chose those assumptions and model inputs which were the most conservative<sup>11</sup> to assure this effect was adequately captured and quantified.<sup>12</sup>

AT&T makes a number of other mistakes in arguing its "double counting" claims. First, not all firms will increase prices as alleged by AT&T, and, in fact, some will decrease prices. Second, AT&T confuses a one-time increase in the price level with on-going inflation. Third, AT&T wrongly assumes that general inflation affects present values. Fourth, AT&T's suggested "fix" is unnecessary.

---

<sup>9</sup> AT&T at p. 13.

<sup>10</sup> AT&T at pp. 7-9.

<sup>11</sup> "Conservative" as used here and elsewhere in this Rebuttal means an assumption purposefully chosen so that it will overestimate the extent to which price cap LECs will receive some form of recovery of or offset to the increased cost of SFAS 106, and, in doing so, underestimate the amount for which price cap LECs should be entitled to exogenous cost recovery.

<sup>12</sup> See, USTA Rebuttal, filed July 31, 1992, Godwins Supplemental Report: Response To Objections Raised Regarding Original Study, p. 16, fn. 4; pp. 32, 41-42.

1. Not All Firms Will Raise Prices.

Not all firms offer employee benefit plans subject to SFAS-106, and only some that do will see a direct change in their cost structures due to SFAS-106. At most, the direct impact of SFAS-106 will be on the prices charged by firms that offer such plans. The Godwins study notes that only 32 percent of private sector employees work for firms with OPEB obligations. SFAS-106 will have no direct impact on the prices charged by firms employing the other 68 percent of private sector workers.

Only some firms with OPEB obligations will see a direct change in their cost structures due to SFAS-106. The Godwins study makes the extremely conservative assumption that all firms with OPEB obligations have, until now, ignored those obligations in their pricing decisions. Rational firms seek recovery of all costs in prices whether or not they are subject to a ruling like SFAS-106. That is, most of the direct effect of SFAS-106 identified by Godwins is already incorporated into prices. Therefore, the direct effect on the price level will be even smaller than suggested by Godwins. Of the firms with OPEB obligations, only those whose prices are regulated based on accounting recognition will need to adjust their prices as a direct result of SFAS-106.

The indirect impact of SFAS-106 could fall on all firms, whether they have OPEB obligations or not. To the extent that some prices are directly affected, there will be changes in some input costs and cross effects on the demand for other products. However, the Godwins study points out that SFAS-106 may also lower wages slightly. While the prices charged by some firms will increase due

to slightly higher input costs and cross effects on demand, other firms may see their cost structures shift down, on balance, due to lower wages. Hence, the indirect effects of SFAS-106 may cause some prices to fall.

Thus, AT&T's statement that "all firms" will increase prices to reflect higher costs is misleading. Not even all of the firms with OPEB obligations will raise prices as a direct consequence of SFAS-106, since many prices already discount those obligations. Some firms may raise prices as a result of SFAS-106, but some may lower prices due to the possible decline in wages. The overall impact on GNP-PI will be even smaller than suggested by Godwins. As if to concede this point, AT&T admits that the effects of SFAS-106 on the general price level will be "relatively small and diffuse".<sup>13</sup>

2. A One-time Increase In The Price Level, Not A Permanent Increase In Inflation, Was Used in The Studies.

Much of the discussion of the double counting issue by AT&T and MCI incorrectly portrays a one-time increase in the price level as a permanent ongoing change in the inflation rate.<sup>14</sup> As the Godwins study points out, SFAS-106 causes a one-time increase in the price level.<sup>15</sup> There is no change in the on-going general rate of inflation, however.

---

<sup>13</sup> AT&T at p. 13, fn \*.

<sup>14</sup> See, e.g., AT&T at pp. 13, 29; MCI at p. 30.

<sup>15</sup> Godwins Study at pp. 1, 10-11, 23.

The one-time increase in the GNP-PI causes an increase in the measured rate of inflation over a limited time. For example, if the entire adjustment in the GNP-PI occurs in the first year following the initial SFAS-106 recognition of OPEB liabilities, then the price cap index will increase to reflect slightly higher measured inflation in that year, and in that year only.

AT&T, on the other hand, would have an amount of supposed double counting subtracted from expected medical care inflation in every year of the accrual calculation. Again, while the measured rate of inflation rises for a limited time, the on-going rate of inflation is unchanged. SFAS-106 cannot permanently raise the rate of inflation, since on-going inflation is governed by the rate of money growth, not discrete changes in accounting recognition. AT&T leaps from correcting a one-time increase in the price level to correcting a supposed permanent increase in the rate of inflation. Therefore, AT&T's suggested adjustment is punitive and improper.

3. SWBT's Present Value Calculations Have Been Purged Of Expected General Inflation.

Contrary to the allegation made by AT&T, exogenous cost treatment of the OPEB accrual will not result in double counting of general inflation in the price cap formula. In the calculation of the accrual amount, future nominal OPEB costs are discounted at a nominal long-term rate of interest to arrive at their present value.

SWBT agrees with AT&T's observation that medical care inflation "includes general inflation plus influences that are

specific to the health care sector."<sup>16</sup> The rate of medical care inflation can be split into expected general inflation and expected increases in the real cost of medical care (relative to general inflation). Similarly, the nominal discount rate used in the denominator can be split into a real rate of interest and the expected general rate of inflation.

In the present value calculation the expected rate of general inflation, including the contribution of inflation in the medical care component, is completely canceled out in the calculation of the OPEB accrual. Said differently, present values are always expressed in the dollars of the initial year. Expected general inflation does not add to the value of the accrual. AT&T's contention to the contrary is wrong. (This flaw in AT&T's claim is described further in Appendix I, attached hereto.<sup>17</sup>)

4. The GNP-PI Used In The Price Cap Index Should Include The Medical Care Component.

Conceptually, the price cap index represents a cost/productivity target that is applied to revenue subject to price cap regulation. The price cap index (absent the exogenous adjustment for SFAS-106) is intended to allow sufficient opportunity for revenue to cover current-accounting payments of medical benefits. The GNP-PI component of the price index formula

---

<sup>16</sup> AT&T at p. 13, fn.\*\*.

<sup>17</sup> The OPEB accrual is unaffected by inflation in the total GNP-PI. As Appendix I demonstrates, the "correction" proposed by AT&T is equivalent to discounting a flow of nominal payments at a rate that doubles the premium for the expected rate of inflation.

is intended to track overall input price increases. Even if SFAS-106 had not been adopted (or if the Commission had not adopted this GAAP change), price cap LECs would experience medical care inflation in their OPEB and other health care related expenses. The portion of GNP-PI growth due to medical care inflation would operate within the price cap framework to reflect the price cap LEC's cost changes due to medical care inflation.

The price cap index should incorporate actual inflation in the total GNP-PI, not inflation in the GNP-PI net of the medical care component. This is entirely consistent with SWBT's request for exogenous treatment of only the incremental SFAS-106 cost, or the total SFAS-106 accrual less the current-accounting payment of OPEB benefits.

The price cap index, through GNP-PI, will reflect actual inflation in current payments of medical care benefits, potentially increasing the revenue to be matched against current-accounting (pay-as-you-go) OPEB costs, but the same payments will be deducted from the OPEB accrual. In other words, current-accounting payments of OPEB benefits will be treated, essentially, as a reduction in exogenous costs, and they will net out of the price cap index. This procedure avoids double counting of medical care inflation.<sup>18</sup>

Also, the price cap index formula already contains an explicit mechanism to ensure that exogenous cost adjustments and

---

<sup>18</sup> This aspect of SWBT's request is apparently ignored by MCI. MCI alleges that the rate of inflation used in the price cap index should exclude the contribution of the medical care component to avoid double counting. MCI at p. 31. Because current-accounting OPEB costs are excluded from the calculated exogenous adjustment as described above, the Commission should reject MCI's argument.

the GNP-PI-less-productivity adjustment are kept separate. This mechanism is a fraction, denoted "w", which reduces the effect of GNP-PI when exogenous cost increases are present.<sup>19</sup> Therefore, exogenous cost treatment of the incremental SFAS-106 costs will not double count medical care inflation.

C. Prefunding Need Not Be Required.

AT&T argues that OPEB costs must be funded to qualify for exogenous treatment.<sup>20</sup> Without such a limit, AT&T claims that the LECs could later divert such funds to other purposes.<sup>21</sup> AT&T states that LECs have already formed VEBA trusts to fund portions of OPEB costs.<sup>22</sup>

The FCC need not consider only prefunded OPEB costs for exogenous treatment. The Commission's exogenous treatment rule contains no such qualification. The SFAS-106 Adoption Order<sup>23</sup> noted that SFAS-106 accrual accounting better reflects the economic substance of the agreement between employees and companies and more properly records the expense over the employees' working lives.

---

<sup>19</sup> The "w" fraction is defined as the price cap R value less the total of all exogenous changes, all divided by R. R is the sum of base period quantities times the price at the time the price caps were last updated. 47 C.F.R. § 61.45(c).

<sup>20</sup> AT&T at p. 14.

<sup>21</sup> AT&T at p. 15.

<sup>22</sup> AT&T at p. 15, fn. \*\*.

<sup>23</sup> Southwestern Bell, GTE Service Corporation Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, 6 FCC Rcd. 7560, (1991, Com. Car. Bur.) (SFAS-106 Adoption Order).

The Commission could have mandated a cash or funding basis of accounting for OPEB benefits but instead elected accrual accounting for the theoretically superior characteristics mentioned. The funding of OPEB benefits is a financing issue which is influenced by many factors such as tax treatment and investment alternatives. Requiring a company to fund in order to receive exogenous treatment would encourage inefficient use of cash, given the limited tax deductible funding vehicles available. Further, exogenous treatment is founded on "events outside the control of the carrier" and LECs control the decision to fund or not. The SFAS-106 requirement does not control funding since LECs could have funded in the past (as some did) or can fund in the future, irrespective of SFAS-106. Adoption of SFAS-106 is the exogenous event, not whether or not a LEC chooses to fund OPEBs. The availability of cash, the limitations on tax advantaged funding vehicles, and alternative investment opportunities are the key determining factors in the OPEB funding decision.

The decision of when and through what means an entity funds such benefits is irrelevant to the accounting issue of how the costs of such benefits should be apportioned to accounting periods. The FASB and the Commission have determined that the proper apportionment is accrual accounting under SFAS-106. The change in accounting policy mandated by the Commission for this type of expense is the exogenous event.

The FASB has also concluded that OPEB funding is a financing question unrelated to the manner in which OPEB costs are

incurred.<sup>24</sup> Accordingly, a company's election to fund is not its basis for determining the incurrence of cost. The OPEB obligation and its associated costs continue to be incurred whether funding occurs or not.<sup>25</sup> The recommendation to create a new accounting criteria (funding) for exogenous treatment is inappropriate for this proceeding and should not be considered.

D. Opponents' Arguments Disregard The Fixed Effect Of SFAS-106.

The oppositions argue that because LECs control OPEB costs, exogenous treatment should not be allowed. Those arguments misinterpret the facts. The level of control over OPEB costs is not solely determinative of exogenous treatment<sup>26</sup> and the oppositions greatly overstate the amount of actual LEC control over the incremental SFAS-106 costs.

The price cap LECs do not control the mandate to implement SFAS-106 accounting on their financial or regulated books. Similarly, the LECs do not control the actuarial method used to calculate the increase in costs mandated by the SFAS-106 adoption. For any given level of pay-as-you-go OPEB benefits,

---

<sup>24</sup> FASB Statement No. 106, para. 150.

<sup>25</sup> In any event, to the extent exogenous treatment is allowed and the company elects not to fund OPEBs, the resulting OPEB liability causes a reduction to rate base. In fact, SWBT has assumed no future funding in its revenue requirement calculation, causing the exogenous adjustment to be lower than it would be otherwise.

<sup>26</sup> Section 61.45(d)(1) of the Commission's Rules does not discuss a "control" standard. Paragraph 166 of the LEC Price Cap Order only states that "in general" the costs should be beyond the control of the carrier.

SFAS-106 has a fixed effect. It is this one-time event for which SWBT seeks exogenous cost treatment.

As shown below, the comparisons to depreciation, equal access and tax expense issues are not compelling. If the Commission imposed an accounting change on LECs relating to depreciation, equal access or taxes,<sup>27</sup> then the Commission would be compelled to make exogenous cost adjustments in the price cap indexes (either up or down) to reflect the accounting change.

1. SFAS-106 Costs Are Unlike Depreciation Rate Changes.

Ad Hoc and AT&T compare the current request for exogenous cost recovery with the Commission's denial of exogenous cost recovery of depreciation rate changes.<sup>28</sup> Ad Hoc argues that in both cases, the LECs exercise control over the level of expense and that such control disqualifies an expense for exogenous treatment.

In the case of capital recovery, however, the Commission allowed an explicit program for rate recovery upon the credible demonstration that the level of depreciation expense incorporated in rates was insufficient to allow for an adequate return of capital.<sup>29</sup> The Transition Benefit Obligation (TBO) and the Reserve Deficiency Amortization (RDA) (for which exogenous treatment has

---

<sup>27</sup> A Commission-mandated accounting change could result from the adoption of a GAAP change or a Part 32 rules change.

<sup>28</sup> Ad Hoc at pp. 8, 14-17; AT&T at p. 18.

<sup>29</sup> Amortization of Depreciation Reserve Imbalance of Local Exchange Carriers, Report and Order, CC Docket No. 87-447, (FCC 88-6) (released January 21, 1988) (RDA Order).

been allowed) are very similar in that they represent amortizations of costs over a fixed number of years.

In its RDA Order, the Commission concluded:

So long as the present large reserve deficiency exists, carriers' rates will not accurately reflect the costs incurred in providing service. It is in the public interest to eliminate this mismatching of costs and rates as quickly as possible so that carriers and ratepayers do not make decisions based on inaccurate data and assumptions. . . . Our initiation of action now will eliminate the risks of economically inefficient pricing signals associated with extending a cure of the large deficiency into the future.<sup>30</sup>

The Commission has already recognized the need to move to SFAS-106 accrual accounting for OPEBs. The need to allow price cap LECs the opportunity to align rates with these costs should also be recognized.

In its 1988 RDA Order the Commission agreed with Ameritech's position that prior regulations had prevented the timely recognition of costs, stating: "the fact that there is a deficiency means that recovery of costs has already been deferred once."<sup>31</sup> The same logic applies in this case.

If the Commission determines that expenses reflected in the regulated cost of service are being significantly understated and decides to increase the level of regulated cost, then the Commission must consider rate recovery for those increased costs. As illustrated above, this is exactly the type of determination that was made in the capital recovery area in 1988 when the Commission allowed rate recovery of the RDA. In the SFAS-106

---

<sup>30</sup> RDA Order at para. 17.

<sup>31</sup> RDA Order at para. 24.

Adoption Order, the Commission has already made the determination that regulated OPEB costs have been understated. In the current case, exogenous cost recovery is the appropriate means of allowing price cap LECs to recover these costs.

2. FCC Rejection Of Exogenous Treatment For Equal Access Is Not Pertinent.

Ad Hoc and AT&T claim that exogenous treatment should be denied because SFAS-106 expenses are similar to equal access expenses.<sup>32</sup> SFAS-106, however, is markedly different from equal access cost in several important ways.

First, the Commission decided to deny exogenous cost treatment for equal access costs based on the fact that the vast majority of traditional equal access costs had already been expended.<sup>33</sup> Through Commission-approved tariffs, LECs had been allowed to recover equal access costs. Since the Commission's order adopting SFAS-106 for interstate regulated accounting was just released in December of 1991, the recognition of SFAS-106 as a regulated cost of service is entirely new and rate recovery has not begun.

Second, the Commission was concerned about "the difficulty of assessing equal access costs, and the corresponding risks that these carriers could willfully or inadvertently shift

---

<sup>32</sup> Ad Hoc at pp. 10, 14-17; AT&T at p. 18.

<sup>33</sup> Policies and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873 (1989) at para. 656 (SFNPRM), and 5 FCC Rcd. 6786 (1990) at para. 180 (LEC Price Cap Order).

switched access costs into the equal access category."<sup>34</sup> SFAS-106 costs are readily identifiable and LECs have no incentive (or ability) under price cap regulation to "shift" SFAS-106 costs among accounts or services.

3. MCI Mischaracterizes the Relationship Between OPEBs and Wages.

MCI mischaracterizes the relationship between benefits and wages, drawing an inappropriate conclusion regarding exogenous treatment of the increased costs caused by SFAS-106 adoption. MCI states that "it is futile to attempt to disconnect OPEB costs from other labor costs for exogenous cost treatment"<sup>35</sup> and that "LECs could offer increased OPEBs and decrease other forms of compensation. . . . In fact, the USTA study itself predicts such a situation."<sup>36</sup>

First, MCI misconstrues the results of the USTA Godwins study regarding the estimated change in the national wage rate. MCI implies that the Godwins study illustrates that LECs can alter the mix of labor compensation between wages and benefits. Such a conclusion illustrates a failure to understand the Godwins study. The Godwins study estimates a possible reduction in the U.S. average wage rate caused by the general equilibrium adjustment in the economy to a higher cost of labor that -- if it occurs -- would represent a savings to all companies in the U.S. economy.

---

<sup>34</sup> LEC Price Cap Order at para. 180.

<sup>35</sup> MCI at pp. 2, 5. See also, AT&T at p. 17, fn. \*\*, p. 18.

<sup>36</sup> MCI at 6 and fn. 8.

Prior to addressing MCI's flawed premise, it is important to note that the national wage rate effect estimated by Godwins is extremely conservative.<sup>37</sup> The estimated wage reduction is based on a very conservative assumption that all firms in the U.S. economy have not yet reflected the true costs of OPEBs in their pricing and resource allocation decisions and that they subsequently do so at the same time that the regulated price cap LECs are required to adopt SFAS-106. However, companies not subject to regulation have had the opportunity to reflect the economic cost of OPEBs in their business decisions all along. Because these other companies have not been prohibited from recognizing true economic costs in their pricing decisions, it is clear that the Godwins estimate of the wage rate effect is overestimated and the need for exogenous cost recovery is underestimated.<sup>38</sup> SWBT contends -- and others on the record in this proceeding agree<sup>39</sup> -- that this key Godwins assumption is not realistic, but SWBT is willing to support use of this assumption in the Godwins study estimate to explicitly ensure that the Commission has a very conservative estimate with which to work.

Second, though not relevant to the request for exogenous treatment, MCI tends to grossly exaggerate the extent to which

---

<sup>37</sup> See fn. 11, supra.

<sup>38</sup> Recall, that in the same conservative fashion, the Godwins Study over-estimated the one-time effect of SFAS-106 on GNP-PI.

<sup>39</sup> See generally, e.g., the NERA Study and the Direct Cases of Pacific and Rochester.

price cap LECs have control over the mix between wages and OPEBs.<sup>40</sup> SWBT operates in a broad market for employees, with its wage rates, salaries and OPEBs affected by the wage rates, salaries and OPEBs offered by other companies in the U.S. that employ labor of comparable skill and talent. Moreover, three-fourths of SWBT's employees are members of labor unions that bargain for levels of wages and benefits with SWBT's management. For these reasons, SWBT's management does not have total control of either the level of wages and OPEBs or the relative mix between the two. Importantly, however, SWBT has not asked the Commission to allow exogenous cost recovery for changes in the level of wages or OPEBs; we have requested exogenous cost treatment for only the increased cost associated with the mandated adoption of SFAS-106. Thus, MCI's concerns are completely misplaced.

Third, assuming *arguendo* that control over SFAS-106 costs is even an issue, MCI's concern does not apply to the Transition Benefit Obligation (TBO), which represents the majority of the incremental SFAS-106 costs. The TBO constitutes the employer's obligation to current and future retirees for nonpension benefits that were already earned as of the implementation date of SFAS-106. Accrual accounting for OPEBs (like accrual accounting for other expenses, including SFAS 87, Accrual Accounting for Pensions) requires that expenses be recorded as the obligation is realized.

---

<sup>40</sup> MCI at pp. 6-7. Note, however that the study on which MCI relies recognizes that OPEBs are fairly fixed obligations. See, H. Fred Mittelstaedt and Mark Warshawsky, The Impact of Liabilities for Retiree Health Benefits on Share Prices, Federal Reserve Board Paper #156, April 1991, p. 3.